Current Issue Review 87-2E

FEDERAL SPENDING: CHANGING TRENDS

Marion G. Wrobel
Senior Analyst

20 January 1987
Revised 19 October 1990

Library of Parliament
Bibliothèque du Parlement

Research Branch

91-04800/

The Research Branch of the Library of Parliament works exclusively for Parliament, conducting research and providing information for Committees and Members of the Senate and the House of Commons. This service is extended without partisan bias in such forms as Reports, Background Papers and Issue Reviews. Research Officers in the Branch are also available for personal consultation in their respective fields of expertise.

© Minister of Supply and Services Canada 1991
Cat. No. YM32-1/87-2-1990-10E
ISBN 0-660-13877-8

N.B. Any substantive changes in this publication which have been made since the preceding issue are indicated in **bold print.**

CE DOCUMENT EST AUSSI PUBLIÉ EN FRANÇAIS

CANADA

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

FEDERAL SPENDING: CHANGING TRENDS

ISSUE DEFINITION

Since 1970, total federal government expenditures have increased from $14,016 million to over $145,000 million, a compound annual growth rate of 12.1%. To put this in perspective, federal expenditures, which accounted for 16% of Gross Domestic Product (GDP) in early 1970, in early 1985 had grown to 25% of GDP and now account for 21.4%.

This trend in spending originated many decades ago. This paper is concerned with only the more recent growth and explores not so much the aggregate level of expenditures as changes in the various components of spending. It will examine those components which account for total expenditure growth and explain why they do so.

BACKGROUND AND ANALYSIS

A. National Accounts Basis

Figure 1, page 3, presents one approach to federal government expenditures, using national accounts data. It outlines the major components of expenditures: transfers to persons, transfers to business, transfers to provinces and interest on debt. Expenditures on goods and services represent the consumption element of government spending, their effect on the economy being equivalent to that of private sector spending. This component has been remarkably constant as a proportion of GDP, staying at about the 5% level between 1970 and 1985. Since 1985, however, it has fallen considerably so that it now stands at just over 4% of GDP. It is therefore not presented in the figure. Its

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

importance relative to the federal budget has been declining, however. In 1970, expenditures on goods and services accounted for 30.5% of federal spending, whereas they accounted for only 19.4% in the past four quarters.

Growth in government spending has occurred primarily in the area of transfer payments. Figure 1 presents the major components of these transfers.

Transfers to persons have been traditionally the largest component of these expenditures. In 1970, they amounted to 4.5% of GDP whereas they now amount to about 6.0% of GDP. From late 1982 to the end of 1986, these transfers ranged between 6.5% and 7.2% of GDP.

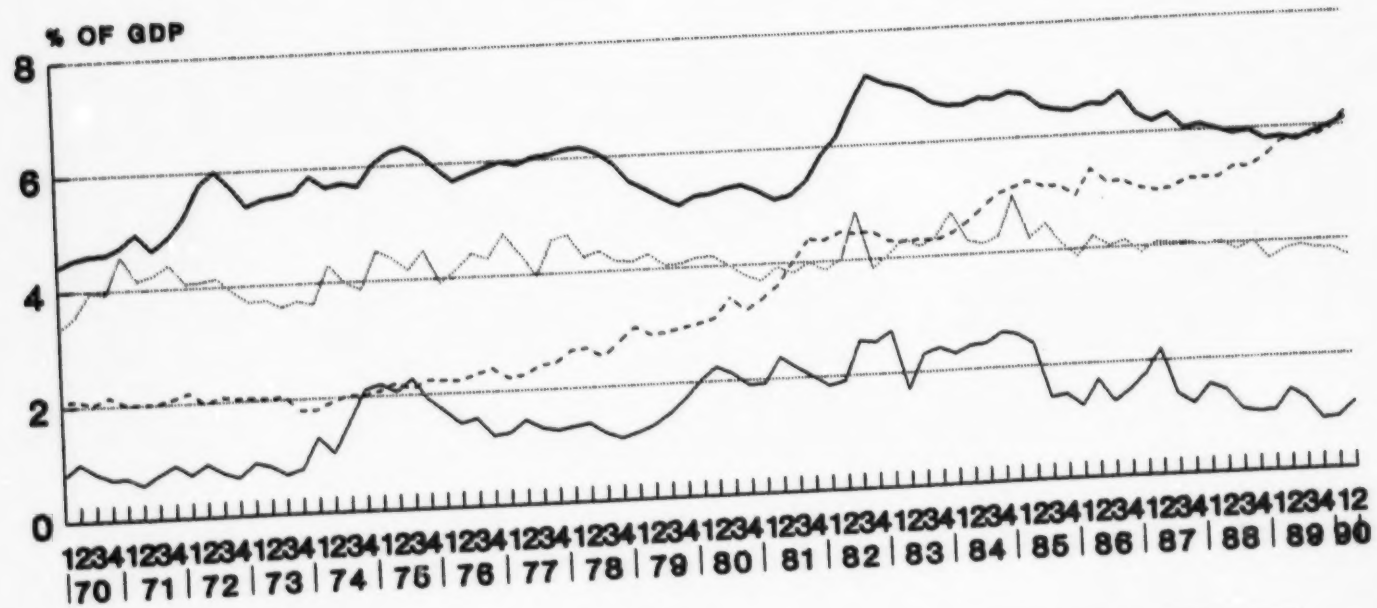
Transfers to business (capital assistance and subsidies) now equal about 1% of GDP. In 1970, business transfers stood at 0.8% of GDP. They peaked during the period 1981 to mid 1985, averaging about 2.3% of GDP. These transfers have been declining almost continuously since then.

Transfers to provinces are today only a slightly higher percentage of GDP than they were in 1970. The average over the entire period is a little higher than indicated by these end points.

The final major component of federal spending relates to the interest paid on the public debt. In 1970 these debt service charges amounted to 2.1% of GDP. Now they average 5.9% of GDP and 27.7% of all federal spending. The third quarter of 1989 marked a watershed with debt charges exceeding, for the first time since 1970, transfers to persons. Debt charges are, in a sense, the deferred tax that the present generation of taxpayers must pay for the expenditures of previous generations. They are directly a function of two variables: the interest rate paid on the debt outstanding, and the size of that debt. The size of the debt is essentially a sum of past deficits. Thus the debt in any period can be viewed as a stock of deferred taxes and debt charges that have become the present generation's responsibility.

Debt charges, measured as a percentage of GDP, have been growing since the mid 1970s, when the ratio of total liabilities to GDP reached its lowest point. The very rapid growth in debt charges since late 1982 is associated with the very high real interest rates that the government is paying on its debt. The effective ex post real interest rate on the federal debt has exceeded 7% on average since 1981.

FEDERAL SPENDING
AS A % OF GDP
1970:Q1 TO 1990:Q2



NATIONAL ACCOUNTS BASIS

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

This discussion has shed limited light on the changing nature of federal expenditures. It has described how the government's role as a consumer has remained relatively constant while its role as a redistributior of income has increased. Further, past programs are being paid for today through the mechanism of the public debt and its associated debt charges. But this description is still far too broad to give any real indication as to what is happening with expenditures.

B. Another View: The Envelope System

Another perspective on this issue can be obtained by examining federal expenditures according to the envelope system used by the federal government. Table 1, page 5, presents these statistics, showing the current allocation of expenditures to their appropriate envelopes. The Economic and Regional Development envelope is the sum of what was previously the Energy and Economic Development envelopes; Social Development now includes the Social Affairs and Justice and Legal envelopes of the past. The largest program growth has, in fact, been within the Social Development envelope, which in fiscal year 1977 amounted to 9.2% of GDP. In fiscal 1989, it accounted for 10.1% of GDP and for 60.3% of program expenditures. The only other program envelope whose growth has at least kept pace with GDP growth is Defence, which accounted for 1.6% of GDP in FY 1977 and accounted for 1.9% in 1989.

The public accounts measure of expenditures as demonstrated in the envelope system, tells the same story as the national accounts; namely, that the growth of public debt charges has been phenomenal. In 1977 they accounted for 11.7% of total federal spending and equalled 2.2% of GDP. In FY 1989, they accounted for 24.5% of total federal spending and equalled 5.45% of GDP. The federal government has now abandoned the envelope system as a means of controlling expenditures.

1. Spending Trends in 1990-91

During the first five months of fiscal year 1990-91, April to August inclusive, total net federal spending increased by 9% over the same five-month period in the previous fiscal year. Total program spending

TABLE I

EXPENDITURES BY ENVELOPE
AS A % of GDP

Fiscal Year Ending March 31	Economic Regional Develop.	Social Develop.	Services To Gov't	Parliament	Defence	External Affairs and Aid	Fiscal Arrange-ments	Program Expen-ditures	Public Debt	Total
1977	3.01%	9.20%	1.02%	0.04%	1.61%	0.54%	1.51%	16.93%	2.24%	19.17%
1978	2.83%	9.24%	1.03%	0.04%	1.65%	0.54%	1.38%	16.72%	2.41%	19.12%
1979	2.44%	8.86%	0.95%	0.04%	1.57%	0.51%	1.15%	15.53%	2.70%	18.25%
1980	2.62%	7.99%	0.78%	0.03%	1.48%	0.47%	1.22%	14.58%	2.86%	17.45%
1981	2.57%	7.54%	0.80%	0.04%	1.47%	0.41%	1.15%	13.99%	3.11%	17.11%
1982	2.30%	7.83%	0.99%	0.04%	1.64%	0.47%	1.29%	14.55%	4.10%	18.65%
1983	2.98%	8.62%	0.74%	0.04%	1.81%	0.53%	1.46%	16.17%	4.38%	20.54%
1984	2.81%	9.04%	0.84%	0.04%	1.85%	0.48%	1.39%	16.45%	4.22%	20.67%
1985	3.18%	10.90%	0.81%	0.04%	1.92%	0.56%	1.29%	18.70%	4.85%	23.55%
1986	2.47%	10.81%	0.93%	0.04%	1.90%	0.52%	1.24%	17.89%	5.31%	23.20%
1987	2.31%	10.69%	0.78%	0.04%	1.96%	0.57%	1.24%	17.58%	5.22%	22.80%
1988	2.56%	10.30%	0.74%	0.04%	1.89%	0.61%	1.20%	17.34%	5.29%	22.64%
1989	2.27%	10.10%	0.66%	0.04%	1.89%	0.60%	1.19%	16.75%	5.45%	22.21%

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

increased by 7.4%. The largest contribution to higher program spending involved Unemployment Insurance benefits, which increased by 21%. The next largest contribution involved Canada Assistance Plan payments, which increased by 17%. Public debt charges increased by 12.6%.

C. Spending on Social Services

In fiscal year 1986-87, the federal government spent $41,711 million on social services, as defined by Statistics Canada. The expenditures grew by 3.7% over the previous fiscal year. Over three years to 1986-87, social service expenditures increased by almost 20%. These expenditures constitute the major part of program spending and as such are a good subject for additional scrutiny. In addition, as a number of them were (and still are) subject to automatic indexation through much of the 1970s and early 1980s, they provide a convenient area to test the assertion that indexation has contributed to the rapid growth of government expenditures.

The two most significant programs are old age security payments and unemployment insurance. Gross expenditures on these are currently in the $14 billion range for the OAS system and under $11 billion for UIC. The amounts spent on family allowances, though smaller, are still important.

1. Old Age Security and Related Programs

The Old Age Security (OAS) provides a universal taxable benefit to anyone over the age of 65 who meets certain residence requirements. This benefit is indexed quarterly to changes in the Consumer Price Index. It has been indexed, off and on, to the rate of inflation since 1971. The OAS is complemented by two other programs for the elderly: Guaranteed Income Supplement (GIS) and the Spouse's Allowance (SPA). These programs put to rest the myth that selectivity necessarily reduces program cost. Although the system has become more selective, it has also become more generous and thus more expensive.

After 1952, the system of old age pensions was completely universal; however, with the introduction of the GIS, it is becoming

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

increasingly selective. This becomes clear if we consider the relationship between the maximum OAS and GIS rates. In 1971 the GIS maximum was 69% of the OAS payment. Today, it is 119% of the OAS rate. Put another way, the OAS payments have stayed relatively constant over the past 15 years; when measured in real dollars, they have increased by only 13%, while the maximum GIS rate has more than doubled.

From 1970 to 1988, total net payments for Old Age Security increased by a factor of approximately 5.7 while those for the Guaranteed Income Supplement increased by a factor of 12.5. The increase in total outlays is a function of two variables: annual payments per recipient and the number of recipients. It is clear that the major determinant of total OAS payments is the growth in recipient population. If we had kept the real value of benefits constant at 1970 levels, the total OAS bill in 1988 would have been $9,373 million rather than $10,774 million, a reduction of only 12.5%. This is not true of the GIS, for which the major cause of expenditure increases has been the growth in the real value of payments. If the real value of average GIS benefits had been held constant at their 1970 levels, total payments would have been $2,368 million in 1988, rather than $3,725 million, a reduction of 36%.

Why have real GIS payments grown so much and what are their component parts? Does the growth of GIS payments reflect an increasing incidence of poverty among the elderly or does it rather represent an increasing generosity on the part of the federal government? There are several ways of looking at these questions. The growth in the number of GIS beneficiaries has been only slightly higher than the growth in the number of OAS beneficiaries. Interestingly, though, the number of recipients receiving the full benefit has steadily declined, while the number receiving a partial benefit has grown to three times its 1970 number.

The GIS was actually viewed as a temporary measure when it was introduced. That was the period when the Canada Pension Plan (CPP) came into existence. The GIS was intended to help those who did not or could not participate in the CPP. As CPP participation increased, however, the need for the GIS was to diminish. Although the number of recipients of

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

full benefits has declined as CPP participation has increased, the number of recipients of partial benefits has increased. One explanation for this is the nature of the tax back regime. Income other than OAS payments is taxed back at a rate of 50%. The point at which partial benefits cease to exist is when income is equal to two times the level of GIS maximum benefits. This cut off point grows with the GIS. The government has decided in the past that the GIS maximum should grow in real terms and it has used ad hoc increases to achieve this. (The GIS is also fully indexed to CPI changes.) This means that the cut off point has also grown in real terms. As a result a greater proportion of the elderly population has become eligible for partial GIS payments.

To put the discussion of OAS and GIS in perspective, we can look at their relative shares of GDP. In 1970, OAS payments accounted for 1.8% of GDP. This ratio fell to 1.6% and remained at that level until 1982 when it reverted to 1.8%, where it has stayed. Because OAS benefits have increased only slightly in real terms over this period, real GDP growth was able to offset the increase in the OAS eligible population. The pattern for the GIS is quite different. In 1970, GIS payments represented 0.3% of GDP. This ratio increased to 0.5% in 1971 and remained at that level for ten years. In 1981 it increased to 0.6% of GDP and in 1985 was at 0.7%. GIS maximum benefits have increased substantially in real terms, and because of the nature of the tax back mechanism, the eligible population has also increased. Thus a program which was initially viewed as temporary has more than doubled in relation to the size of the economy.

2. Unemployment Insurance

Total Unemployment Insurance (UI) benefits are today in the neighbourhood of $11,500 million annually. In fiscal year (FY) 1970, these benefits totalled less than $550 million. A comparison of these dollar amounts over the past two decades suffers from the same problems that plague all such comparisons: changes in the relevant price index and scale of the economy distort the magnitude of the differences. Nevertheless, the growth in UI benefits is not an illusion. In the late 1960s they equalled 0.56% of GDP, whereas since 1982 they have amounted to 2.28% of GDP. We

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

cannot appeal to inflation or increases in the absolute numbers of unemployed to explain this growth.

The obvious variable to consider when explaining the ratio of UI benefits to GDP is the unemployment rate. But this alone is not responsible. The unemployment rate since 1982 has been 2.7 times the average rate of that of the late 1960s, but the ratio of UI benefits to GDP is 4 times higher. Something else has happened to make the unemployment insurance system as expensive as it is.

Two institutional changes help to explain the growth. In 1971 the system was significantly liberalized. This increased benefit levels and made them taxable; it loosened eligibility requirements; it increased both the duration of benefits and increased overall coverage. It is estimated here, that this institutional change increased the ratio of UI benefits to GDP by 0.56 percentage points for every level of the unemployment rate. In addition to this direct effect, the institutional change increased the cost of the UI program to the extent that it increased the rate of unemployment. Estimates of this UI-induced unemployment range from 0.4 to 1.9 percentage points.

In 1978, the unemployment insurance system was tightened up in light of dissatisfaction with some aspects of the 1971 reforms. It is apparent that these new changes were successful: even though the average unemployment rate increased after 1978, the ratio of UI benefits to GDP actually fell. It is estimated here, however, that the 1978 changes countered only about one-half of the 1971 changes. Thus the present system is still more generous than the one in existence prior to 1971.

The recent cost of the UI system is the result mostly of the high rates of unemployment that started with the recession, though they have since fallen. The benefit/GDP ratio varies approximately 0.5 percentage points for every 3 percentage point change in the unemployment rate. But the decline in unemployment has slowed down considerably and thus we should continue to see benefit/GDP ratios considerably higher than those of 1970.

What is clear, nevertheless, is the sensitivity of the size of the program to institutional change. Such change has a major and rapid

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

effect on the size of the UI program. For example, implementing the recommendations of the Forget Commission could have the same effect on program cost as a three percentage point drop in the unemployment rate.

The federal government introduced Bill C-21 in June 1989 in an attempt to reduce the disincentive effects of unemployment insurance and to reduce federal expenditures in this field. This bill, which is currently stalled in the Senate, would impose stricter entrance requirements for UI benefits, reduce the duration of those benefits on average, and withdraw federal government financial contributions to this program. It is exepected these proposed measures would save the government $1,900 million annually.

3. Family Allowances

The pattern of family allowance expenditures is relevant to this discussion for a number of reasons. In the first place, family allowances are an important component of federal spending on social development. Family allowance payments amount to about $2,500 million and are delivered to over 3.6 million families. But this program is also interesting in that it demonstrates how expenditure patterns can be totally misleading. Changes in the design of the program since 1970 make it difficult to discuss trends. The program started out as a modest non-taxable benefit available without regard to income. It then became a taxable benefit in 1974 and was substantially increased. In 1979, the level was reduced and a Child Tax Credit (CTC) introduced.

The number of children for whom family allowances are delivered, peaked in 1975 at 7.3 million. It is now about 11% lower.

In 1970, family allowance payments amounted to 0.6% of GDP. This increased to 1.2% in 1974 as a result of the big increase in gross benefits per child. The ratio of payments to GDP declined to 0.9% over the next four years and then further declined to 0.6%. This is mostly the result of the decrease in the number of eligible children and the 1979 reduction when the CTC was introduced.

At present, the Child Tax Credit is technically considered to be a tax expenditure and as such does not show up in expenditure or revenue figures. But this exclusion is purely arbitrary and the CTC could

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

just as easily be considered as an expenditure with "tax back" provisions like the GIS. If we treat it as such and combine it with the family allowance, the pattern of child expenditures is as follows: from 0.6% of GDP in 1970, these expenditures increased to 1.2% in the mid-1970s when the number of children peaked; the ratio then declined slightly, only to jump up again to 1.3% with the introduction of the CTC; finally, it fell to its present level of 0.9% of GDP as a consequence of a further decline in the client population.

The April 1989 federal budget introduced a benefit reduction scheme which would apply to Old Age Pensions and Family Allowance Payments. Both are now taxed through the personal income tax system. When these benefit reduction provisions are fully in place, benefits will be reduced by $0.15 for every dollar of individual income in excess of $50,000.

D. Debt Charges

The discussion above has dealt with various program expenditures of the federal government. A large and growing component of government spending, however, is interest charges on accumulated government debt. In 1970 these charges amounted to $1,800 million whereas they could reach $40,000 million this fiscal year. As a percentage of GDP, they have more than doubled, to almost 6%.

It is popular to blame this component of expenditure on monetary policy rather than fiscal policy, citing the role of high real interest rates since 1982-83. Debt charges could be reduced substantially by a policy designed to reduce prevailing interest rates, it is argued. For example, at the time of the release of the 1988 Main Estimates, it was claimed that a one percentage point drop in interest rates could reduce debt payments by $1.4 billion.

It is true that real interest rates are today much higher than they were in the 1970s. But during that period we experienced accelerating inflation which left ex post real interest rates often at very low, even negative levels. The desirability of repeating such an experience is not at all obvious. It is not at all clear that the Bank of

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

Canada could reduce real interest rates through a policy of monetary expansion. Nor is it obvious that all of today's high debt charges can be blamed solely on high interest rates. There is another important variable to consider; namely, the stock of debt to which these interest charges are applied.

In the first half of the 1970s, debt charges averaged 2.2% of GDP. This was associated with a falling debt to GNP ratio and low, often negative, real interest rates. After 1976, debt charges rose steadily to over 4% of GDP even though real interest rates continued to be relatively low. This was because the stock of debt was growing. The debt to GDP ratio grew over this period as the federal government started to run considerable deficits.

Starting in 1984, debt charges exceeded 5% of GDP. During this time, while the stock of debt grew rapidly, real interest rates were extremely high by recent standards. It is this factor which has led some analysts to argue that high debt charges are a matter for monetary policy.

To test this assertion we estimated the effect on debt charges of a 3% real interest rate, starting in fiscal year 1982. Although a 3% real rate is still high by the standards of the 1970s, when real rates of interest were unusually low, it is compatible with the long run interest rate experienced in Canada.

The average ratio of debt charges to GDP since fiscal 1982 has been 4.8%. With a 3% real interest rate this ratio would have fallen to 3.64% on average. The debt to GDP ratio would have fallen marginally as well, from 59.47% to 57.4% at the end of 1986-87. The average ratio of debt charges to GDP would, however, still have been significantly higher than anything experienced in the 1970s. The impact of such a lowering of interest rates on the size of the debt and corresponding debt charges has been overestimated. That action limits the ratio of gross debt charges to gross public debt, as published by the Department of Finance, to 3% in real terms. But a policy which lowered interest rates today would affect only new borrowing. It would be several years before a sustained drop in interest rates affected the entire stock of outstanding debt.

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

E. 1990 Federal Budget

On 20 February 1990, the Hon. Michael H. Wilson tabled his sixth budget. The highlight of this budget was an expenditure control plan, designed to reduce total spending by $6,111 million over two years and $16,689 million over the next five years. This plan contains four elements. First, a number of programs, most notably Canada Assistance Plan payments to Ontario, British Columbia and Alberta, are to grow by no more than 5% per annum over the next two years. Second, Established Programs Financing will be frozen on a per capita basis for two years. Third, some programs are to be reduced, including spending on social housing, Health and Welfare and Secretary of State grants. Finally, some programs are to be eliminated - these include the Canadian Exploration Incentives Program, the OSLO oil sands project and the Polar 8 Icebreaker.

These measures should reduce program spending to 14.2% of GDP by 1994-95. Today they stand at 16% of GDP.

PARLIAMENTARY ACTION

In a very real sense, the history of government expenditures is the result of parliamentary action in one form or another. Approximately once a year, the Minister of Finance presents a budget to Parliament in which the government's future spending and taxation plans are outlined. In addition, almost every bill passed in Parliament has some impact on government expenditures.

CHRONOLOGY

June 1971 - The UI system was substantially expanded and liberalized with the passage of Bill C-229.

January 1974 - Family allowance payment was increased to $20 per month per child and began to be treated as taxable income. The monthly payment also became subject to indexation.

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

1977 - Bill C-27 was introduced and passed in 1977 to tighten up the liberalized UI system. It increased eligibility requirements and reduced maximum weeks of benefits for a wide range of UI recipients.

1978 - Child Tax Credit was introduced. Maximum benefit was set at $200 per eligible child.

1979 - Family allowance benefits were reduced by about 22% starting in January.

1983 and 1984 - Indexation factors for government expenditures were limited to 6% and 5% respectively.

May 1985 - The federal budget proposed limiting indexation to CPI changes in excess of 3 percentage points.

November 1986 - The Commission of Inquiry on Unemployment Insurance (C.E. Forget, Chairman) released its Report calling for major changes to the UI system in order to return the program to its insurance function.

SELECTED BUDGETS AND PROJECTED EXPENDITURES

Hon. D.S. Macdonald, May 1976, $39,400 million for 1976-77.
Hon. J. Chrétien, April 1978, $46,900 million for 1978-79.
Hon. J. Crosbie, December 1979, $51,950 million for 1979-80.
Hon. A.J. MacEachen, June 1982, $78,100 million for 1982-83.
Hon. M. Lalonde, February 1984, $96,926 million for 1984-85.
Hon. M. Wilson, February 1986, $116,740 million for 1986-87.
Hon. M. Wilson, February 1987, $122,550 million for 1987-88.
Hon. M. Wilson, February 1988, $132,300 million for 1988-89.
Hon. M. Wilson, April 1989, $142,900 million for 1989-90.
Hon. M. Wilson, February 1990, $147,775 million for 1990-91.

SELECTED REFERENCES

Bird, R.M. The Growth of Government Spending in Canada. Canadian Tax Papers No. 51. Canadian Tax Foundation, Toronto, July 1970.

Canada, Department of Finance. The Fiscal Plan. Ottawa, various dates.

Dingledine, G. A Chronology of Response, The Evolution of Unemployment Insurance from 1940 to 1980. Employment and Immigration Canada, Ottawa, 1981.

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

Gauthier, Gilles. Federal Public Expenditures Part I: Growth. BP 119-E, Research Branch, Library of Parliament, Ottawa.

Prince, M.J. How Ottawa Spends, 1986-87: Tracking the Tories. Methuen, Toronto, 1986.

Saunders, P. and F. Klau. "The Role of the Public Sector." OECD Economic Studies, No. 4, Spring 1985.

The National Finances. Canadian Tax Foundation, Toronto, various issues.